The Effect of Creative Accounting on Firm Performance

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ABSTRACT

This study aims to find out the effect of Creative Accounting in which the intentional manipulation or omissions of amounts or disclosure in financial statements has a significant effect on the firm performance in Egypt, and to detect whether the effect of misreporting assets and equity has a significant effect on attracting investors and minimizing taxes or not. This study uses secondary data obtained from the financial statements of the most active companies in the Egyptian stock exchange market. The findings reveal that Creative Accounting has a significant positive effect on firm financial performance measured by ROA and an insignificant positive effect on ROE and Tobin's Q.

INTRODUCTION

Creative Accounting is used to change reported facts while staying within the confines of accounting regulations and laws, so they reflect what management wants to inform the stakeholders with rather than the company's genuine performance or position. It occurs due to the management's discretion in selecting accounting rules. Producing financial statements that (1) emulate the company's success to be higher than it actually is to attract investors or (2) appear less profitable in order to avoid paying taxes, financial statements have been regarded as a critical component for a successful corporate governance system.

It is usually carried out by a corporation that has reached less than optimal conditions and has begun to use Creative Accounting methods to fraudulently inflate earnings and therefore hide the financial crisis. This approach can lead to tax avoidance and the loss of the investors' hard-earned money. With a request from the company's Board of Directors to falsify the company's financial statements in hopes of disguising losses, aiding in pricing manipulation, profit overstatement, and account falsification by certain questionable stewards, the financial statements became useless.

METHODOLOGY

This study examines the effect of Creative Accounting on firm performance. Secondary data was obtained using financial statements from the Egyptian stock exchange. Population of this study were comprised of all industries excluding banks and non-banking financial institutions, while the sample of the study was made up of 147 of the most active companies in the Egyptian stock exchange market, these data were obtained from 2013 to 2018. Our dependent variable is firm financial performance measured by ROA and ROE and Firm value measured by Tobin's Q and our independent variable is said Creative Accounting which we measure it by the following model:

$$TAC_t = a_1 + a_2(\Delta Rev_t - \Delta Rec_t) + a_3 PPE_t + e\ .$$

And for the control variables firm size which is = Total assets

and financial leverage which is measured by

$$LEV = \frac{Total\ Liabilities}{Total\ Assets}$$

We measured the effect of creative accounting on firm performance by the following 3 models:

1. $ROE_{ti} = a_1 + \beta_1 TAC + \beta_2 Size + \beta_3 LEV + e$
2. $ROA_{ti} = a_1 + \beta_1 TAC + \beta_2 Size + \beta_3 LEV + e$
3. $Tobin's\ Q = a_1 + \beta_1 TAC + \beta_2 Size + \beta_3 LEV + e$

And these models test our hypotheses:

H1: Creative Accounting has a significant relationship with firm performance measured by ROE.

H2: Creative Accounting has a significant relationship with firm performance measured by ROA.

H3: Creative Accounting has a significant relationship with firm performance measured by Tobin's Q.

RESULTS

The findings show that, in model 1 (ROE), the dependent variable showed significance with TAC and LEV and insignificance with size. Regression showed an insignificant relationship for the model that resulted in rejecting our first hypothesis. Model 2 (ROA) has showed that there is significant relationship between ROA and TAC, the regression results showed that 40% of the variance in ROA may be explained by TAC and control variables ,and this means accepting our second hypothesis. In our last model, Model 3 (Tobin'sQ), showed an insignificance relationship that resulted in rejecting our last hypothesis.

CONCLUSION

This study proves that there is a significant relationship with creative accounting and firm performance measured by model 2 (ROA), and the smaller the size of the company the higher the use of Creative Accounting activities occur because bigger-sized companies have auditors and big 4s reviewing their financial statements. This study provides recommendations that can be used for future research to expand the research population into banks and non-banking financial institutions.

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